

In Gold I Trust! But With Some Reservations.....

Marc Faber

In the absence of the gold standard, there is no way to protect savings from confiscation through inflation [...] Deficit spending is simply a scheme for the “hidden” confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statist’s antagonism towards the gold standard.

- Alan Greenspan, Gold and Economic Freedom (1968)

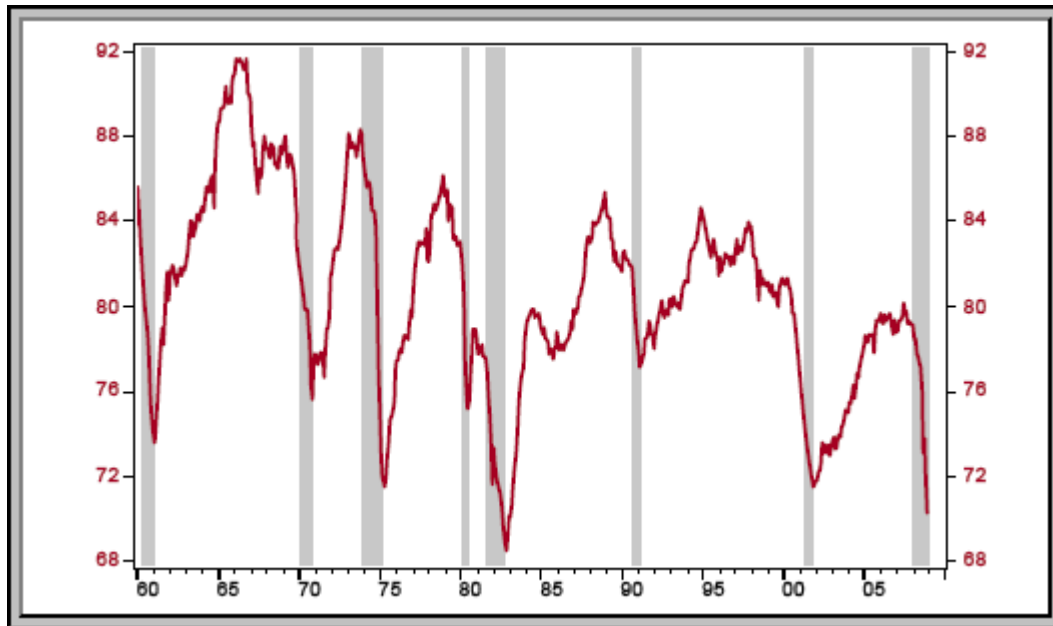
“Innovation has brought about a multitude of new products, such as subprime loans and niche credit programs for immigrants. With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. These improvements have led to rapid growth in subprime mortgage lending . . . fostering constructive innovation that is both responsive to market demand and beneficial to consumers.”

- Alan Greenspan (At the Federal Reserve System’s Fourth Annual Community Affairs Research Conference, Washington, D.C., April 8, 2005)

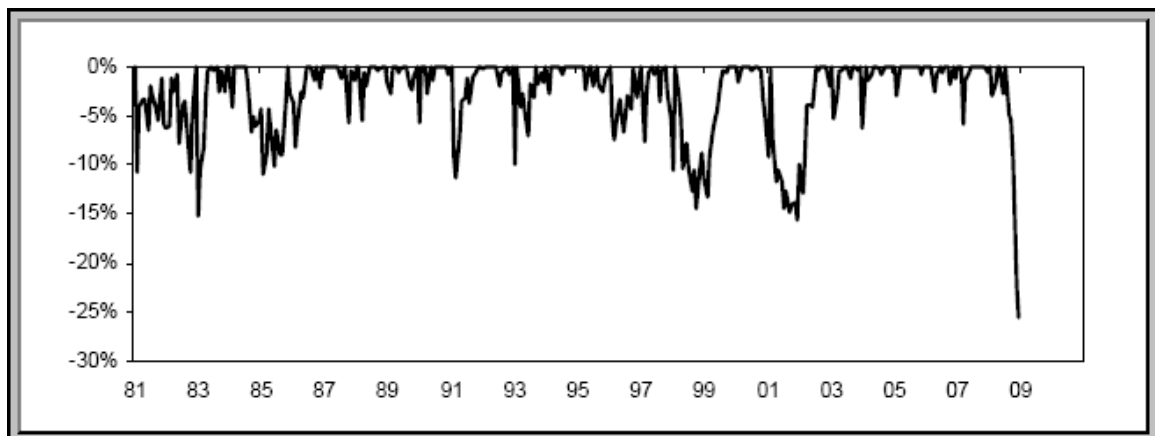
If the governments devalue the currency in order to betray all creditors, you politely call this procedure “inflation.”

- George Bernard Shaw

To put it bluntly, the global economy is in deep trouble! An unprecedented wealth contraction post Second World War has occurred, and industrial production as well as capacity utilization rates, new orders, exports, and incomes are contracting at an unprecedented rate (see Figure 1 and Figure 2).

Figure 1: US Manufacturing Capacity Utilization Rate, 1960 - 2009

Source: David Rosenberg, Merrill Lynch

Figure 2: Asian Emerging Markets Exports, Drawdown from Peak, 1981 - 2009

Source: Bridgewater Associates

Now, I am not trying to downplay the economic downturn. But since I travel extensively all over the world I am actually astonished that, despite horrible economic statistics and despite business being down everywhere (however, exceptions exist such as sales of computer games, guns,

bullets, private label brands, gold coins, safes, and of course - as can be expected - the expansion of the government), economic activity is still at a relatively high level. Maybe people live in denial and do not yet recognize how much more the economy is likely to deteriorate or they take a fatalistic view by thinking about how much money they lost in asset markets and, therefore, decide to have a good time either traveling on holidays or going out at night. But if this is a depression, then I have to say that it is a depression at a relatively high level of prosperity. Personally, I think the global economy will deteriorate far more and that we have, so far, only seen the appetizer of **the** great economic contraction.

My take is that global non-government sector GDP has already contracted by about 10% from its 2007 peak and that it will contract by another 10% to 20% in real terms. I am aware that official statistics by governments do not support this observation, but asset markets seem to confirm the magnitude of the economic contraction (see Figure 3)

Figure 3: CRB Index: Just 10% Above 1999 – 2001 Lows!



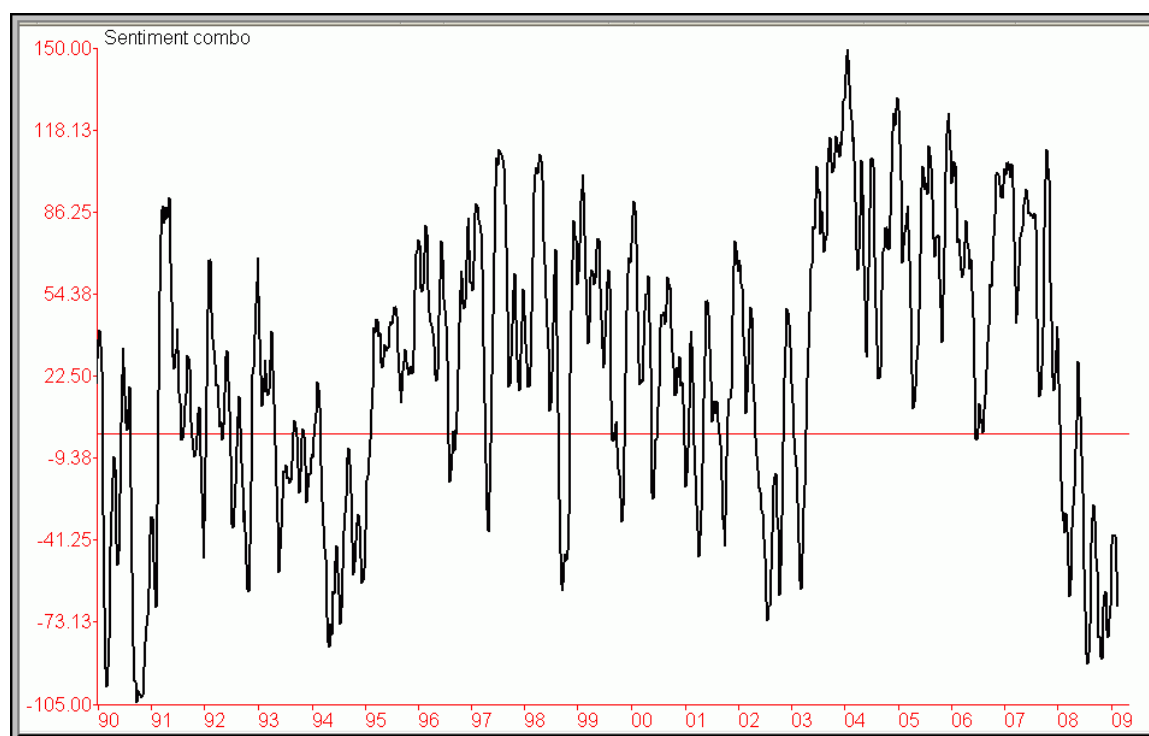
Source: www.credit-suisse

Now, I leave it up to my readers to believe in governments' blatantly dished out lies or in the power of markets to still provide some useful

information (although increasingly distorted by government interventions). But as far as I am concerned, the CRB Index suggests that we are in for a terrific economic slump. This index is in nominal terms around 10% above the 1999 and 2001 lows but in real terms below these lows (I should add that the 1999 and 2001 lows occurred after a 20 years bear market – see Figure 3). The point is simply that some asset markets may already have discounted much of the coming slump.

The poor economic outlook and the devastating decline in all asset prices over the last 15 months is also reflected in historically very low sentiment readings. The 10-week moving average of bulls divided by bulls and bears is currently, as Larry Katz of Market Summary & Forecast points out (www.marketsummaryandforecast.com), in the US at an extremely low level, which in the past has typically been associated with important market lows (see Figure 4).

Figure 4: The 10-Week Moving Average of Bulls Divided by Bulls and Bears

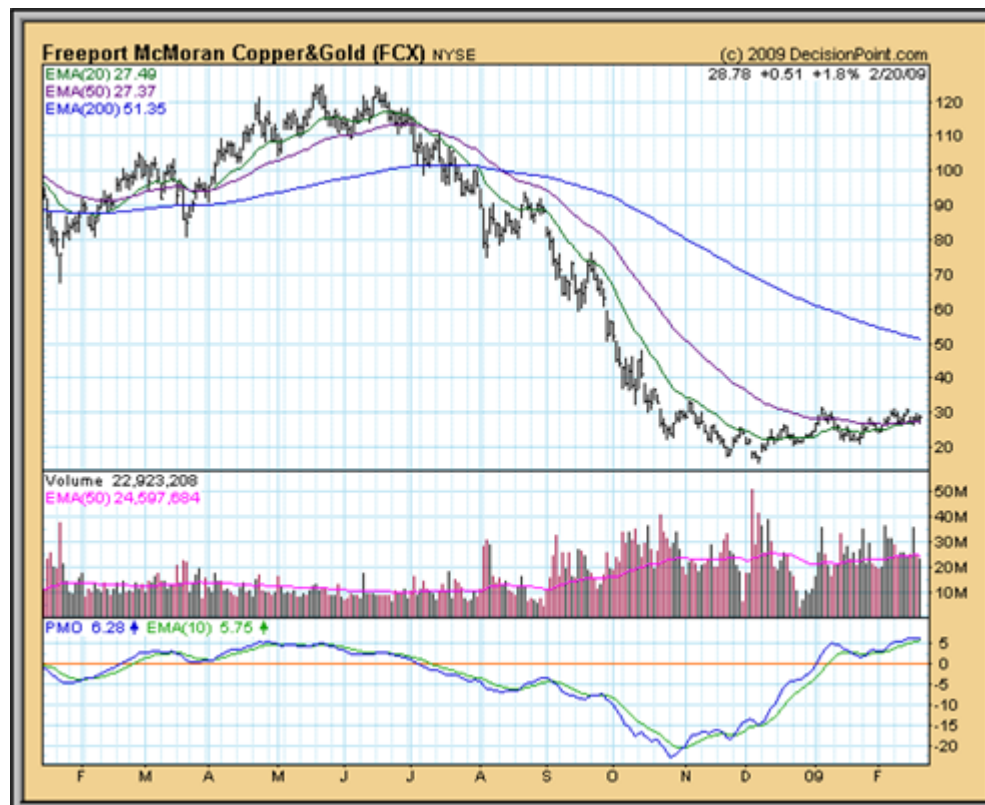


Source: Larry Katz, www.marketsummaryandforecast.com

And whereas market sentiment indicators are not a precise market timing tool, they provide some indication about market top and market low areas. In this respect it should be noted that bullish sentiment reached a peak already in 1997 and again in 2004. Bullish sentiment then trended

down, but the stock market continued to rise until the spring of 2000 and until late 2007 (see Figure 4). So, the reverse could now also occur: sentiment could improve while the market still declines further. All I wish to stress is that there are no precise market timing tools, but indicators like investors' sentiment do provide some indication whether a market is high and in an euphoric phase or low, close to a capitulation phase, and nearing at least an intermediate bottom. I am fully aware that the majority of investors now feel that there are no good news on the horizon and that, therefore, another sell-off to new lows is in the cards. However, the renewed weakness in major indices may have obscured the fact that some stocks and even indices had major rallies since the November lows. Take resource related equities: Newmont Mining has risen from \$21 to over \$40 and Freeport-McMoRan from \$16 to \$30 (see Figure 5).

Figure 5: Hidden Strength Amidst a Weak Stock Market



Source: www.decisionpoint.com

So, whereas I also pay attention to the major indices, I think that stock selection will be more important than it was during the 1982-2000 bull market when just about every stock rallied and drove the indices higher.

Moreover, I have sympathy with Alan Newman, the editor of Cross Currents (www.cross-currents.net), who wrote a few days ago that, “our technical work reveals a sold out stock market. Those looking for a capitulation phase as a catalyst to a reversal are not likely to get one. There can't be a capitulation when investors are already out of the market. Since the October 2007 highs, nearly a quarter-of-a-trillion dollars have flowed out of mutual funds. The capitulation has already occurred.” Alan also points out that several indices such as the Russell 2000, the NASDAQ 100, and the SOX Index are still about 5% higher than they were at the November lows. Moreover, several foreign markets including Hong Kong and China are still up around 20% from their November 2008 lows (see Figure 6).

Figure 6: Some Bright Spots Amidst Extreme Pessimism



Source: www.decisionpoint.com

I may add that Alan Newman further notes that “while we have seen sentiment indicators at more pessimistic levels in the past, the media sound bites admit only one way - down, down and further down.

In internet searches yesterday, Google returned 1.69 million results for 'Dow 7000,' 2.22 million results for 'Dow 6000' and 4.02 million results for 'Dow 5000.' Obviously, some of those results have been archived from the past but the point is clear. Everyone fears what lies over the horizon."

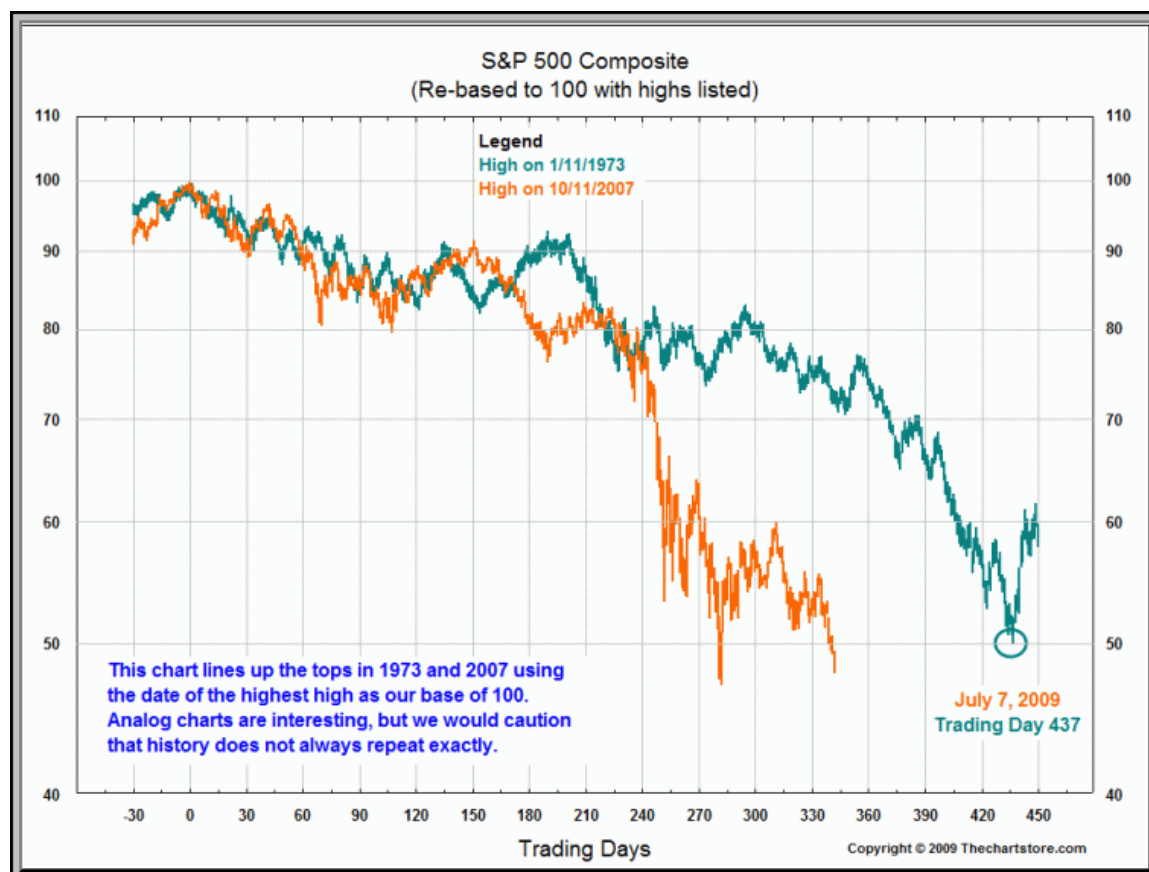
Now, I have no idea whether by year-end 2009 stock markets will be higher than they are today or even lower. However, I want our readers to recall well what sentiment was like in the summer and fall of 2007 when equities peaked out. Just about everybody was widely optimistic about the global economy, the BRICS, synchronized growth forever, and decoupling of emerging economies in case of a US recession. In addition, nobody forecasted a 50% drop in global equity prices (except some pundits who had been forecasting this event since 1987). Now, 15 months after the October 2007 peak and with stock markets down 50% or more from their highs in a very brief period of time, everybody is extremely negative about "everything." Also consider the following: I sit on the board of various investment companies for which the board, aside from protecting investors' interests, is involved in the asset allocation of the funds. (I should point out that if a manager wants to be dishonest it is unlikely that the board will notice it). In 2007, it was practically impossible for me to force the investment managers to reduce equity positions. In one case, following the August 2007 sell-off, one board member suggested to take advantage of this "correction" and to increase the equity exposure substantially because the "global economy and corporate profits were going to continue to grow and because valuations were low." A few days ago, the same board member opposed my idea to increase equity positions from 25% to 30%! On another board, a member's prime recommendation in late 2007 and early 2008 was to "invest heavily in Russia and in Ukraine." Recently, the same board member has been sending out papers about how the world's economy would come to an end and how the S&P would tumble to between 400 and 500. I am not trying to pick on my fellow board members, some of whom are actually very smart. Moreover, the S&P could indeed drop to 400. But I wanted to show the change of mood.

In fact, even I hesitated to be overly negative in late 2007 and in the first part of 2008. Because of the extremely optimistic sentiment that prevailed at the time and because I did not want to offend too many of my clients, I refrained from putting as title of my presentations "The Global Synchronized Boom Will Lead to a Synchronized Bust." Instead, I chose the more diplomatic title "Will the Global Synchronized Boom Lead to a Synchronized Bust?" Nevertheless, the conclusions were the same.

But the point is this: The 2007 – 2009 US bear market has been unprecedented post Second World War in terms of its downside

momentum and its brevity (see Figure 7 and Figure 8). Not surprisingly has the stock market's extreme collapse - against all expectation - brought about bearish sentiment extremes, which in the past were usually associated with temporary rebounds or often with major market lows (see Figure 7 and Figure 8).

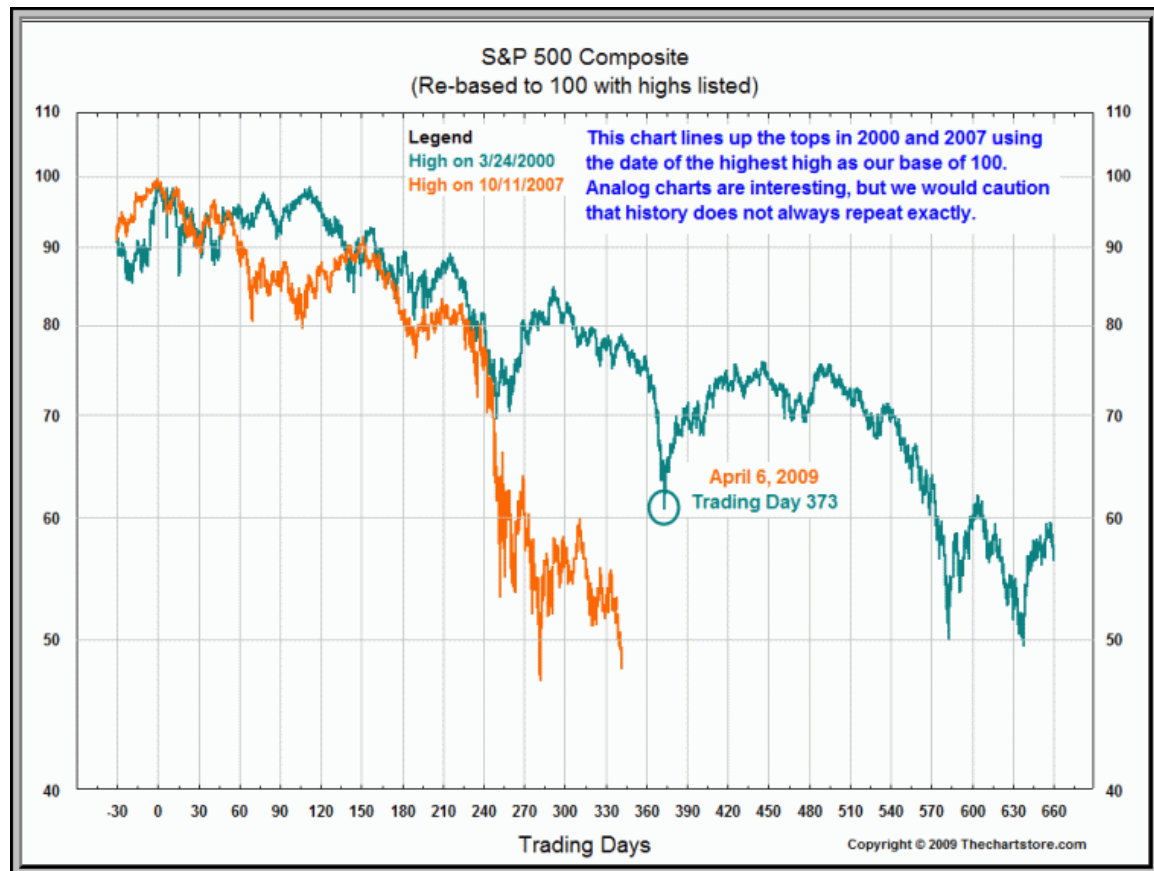
Figure 7: Post Second World War Unprecedented Downside Intensity!



Source: Ron Griess, www.thechartstore.com

What is remarkable is the speed at which stock markets collapsed. So, whereas it took 437 days in the 1973/74 bear market to decline by 50%, we did it in less than 350 days (see Figure 7). Similarly the 2000 to 2003 bear market, which brought about a decline of approximately 50%, lasted more than 630 days (see Figure 8). So, I think it is fair to say that stock markets around the world are very over-sold and that a powerful rally could occur at any time.

Figure 8: A Larger Decline in a Much Shorter Period of Time Than in the 2000 – 2003 Bear Market.



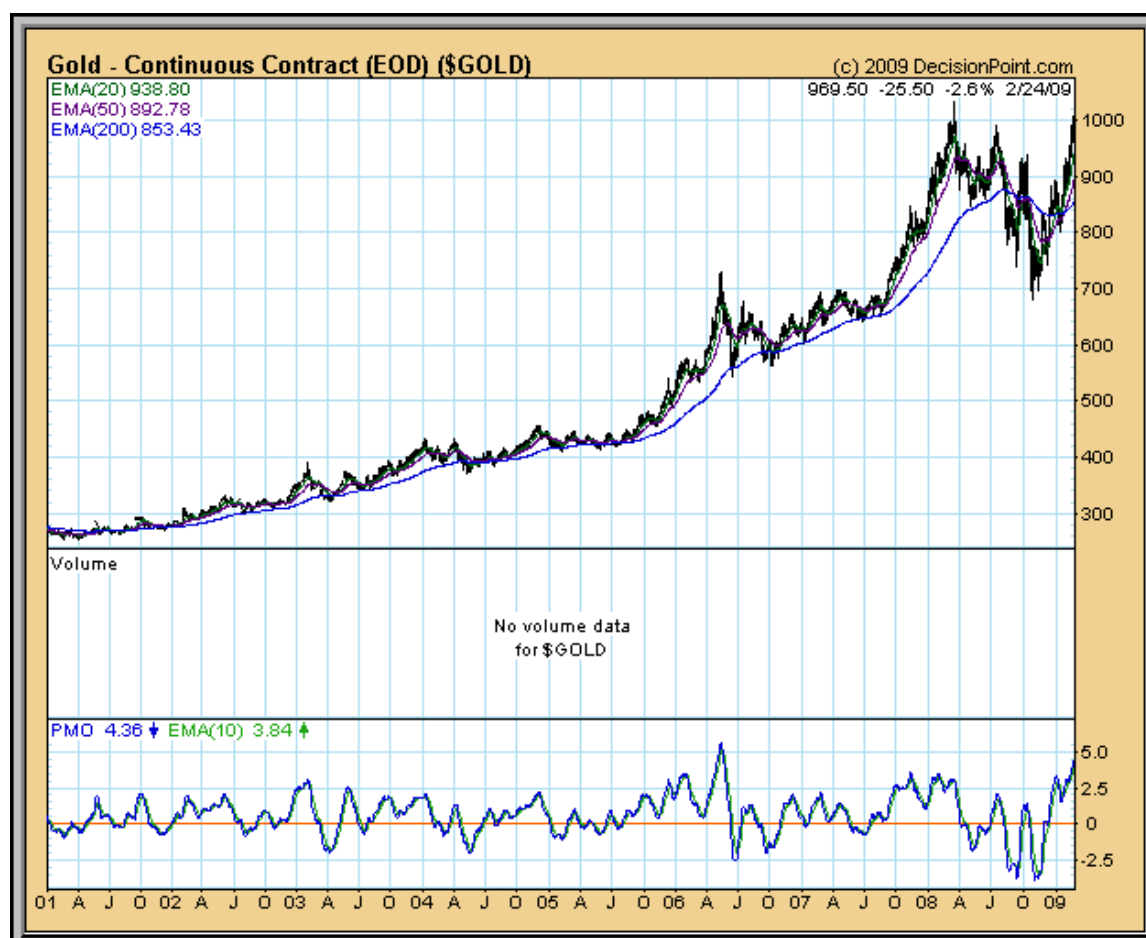
Source: Ron Griess, www.thechartstore.com

This is not to say that a rally will occur right away, but I wish to point out that the risk of shorting currently is quite high, as it would be unusual for stock markets to sell-off far more right away amidst so much gloom and doom. We had a false breakout on the upside in October 2007 when the stock market briefly exceeded the July 2007 highs. Similarly, we could now have a false breakout on the downside below the November 2008 lows, which could be followed by a strong rally.

Still, I wish to clarify my position very clearly: I am extremely negative about the global economy and financial markets **in real terms**. I doubt we shall see global peak economic activity and growth such as we had between 2004 and 2007 for a very long time. Equally, I realize that governments around the world will print money – either without any scruples like Mr. Bernanke who would be Mr. Mugabe’s best central banker or with hesitation like the ECB. But print they will all do, as the mess central banks have created can only be cured through massive

monetary inflation. Also, it should be obvious that the worse the mess that central bankers have created will become (notably the US Fed), the more money will be printed. So, asset prices are likely to rebound one day even as the global economy continues to deteriorate. This brings me to the subject of gold! (See Figure 9.)

Figure 9: Gold, 2000 - 2008



Source: www.decisionpoint.com

I really dislike being called a gold bug. I wish I could be positive about the global economy and social and geopolitical condition, but the more I think about current condition, the more depressed I become. Amidst a global slump I believe that we are moving toward high inflation (a further depreciation in paper money's purchasing power), evil fascism, and vicious military confrontations. In theory, gold would be the best asset to own in this condition. Also, in theory, gold should be the perfect

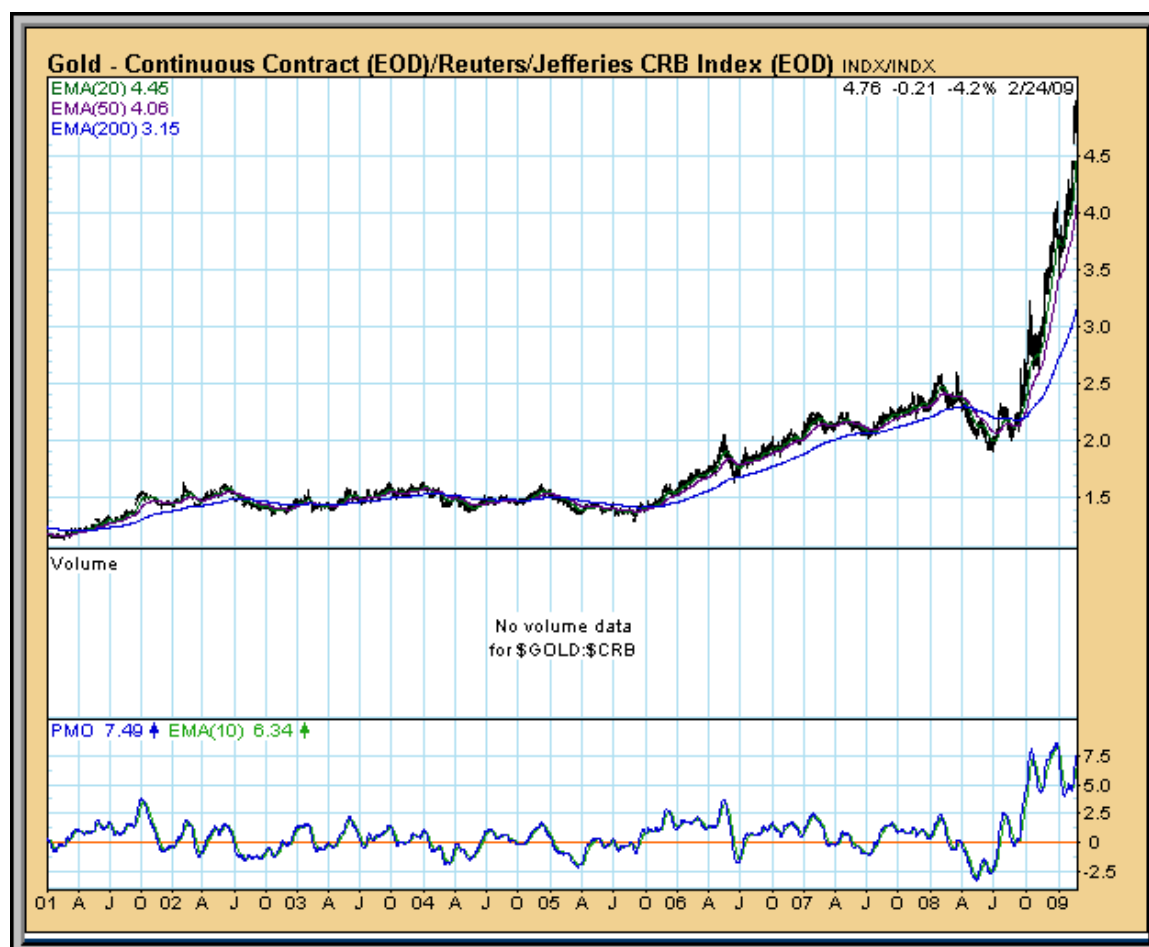
insurance against economic, social, and political Armageddon. However, I have some reservations (see Figure 9 and Figure 10).

Figure 10: Dow Jones Compared to Gold, 1999 - 2008



Source: www.decisionpoint.com

For one, gold has already experienced a powerful bull market between 2001 and the present. As a result, gold has become relatively expensive compared to equities (see Figure 10) and the CRB Index (see Figure 11). I am not suggesting that this outperformance of gold compared to other commodities and equities cannot continue. In fact, I believe that in time one Dow Jones will buy less than one ounce of gold (see Figure 10). However, near term, gold would seem to be both over-bought against the Dow Jones and the CRB Index (see Figure 11 and also Figure 3).

Figure 11: Gold Compared to CRB Index, 2001 - 2008

Source: www.decisionpoint.com

I concede that the overbought condition of gold compared to the Dow Jones and compared to the CRB Index could be corrected by a strong rebound in the Dow and the CRB Index rather than a further downward correction in gold. My bet would be that the CRB Index has significant rebound potential and, therefore, I still like resource related equities such as BHP (BHP), Rio Tinto (RTP), CVRD (RIO), Freeport-McMoRan (FCX - see Figure 5), Xstrata (XTAN SW), and gold mining and exploration companies (I sold my Newmont Mining and Freeport shares whereas I have no intention of selling my physical gold). Still, as mentioned above, we already had some powerful rebounds in most of these shares and some near term caution is advised.

The other concern I have about owning physical gold (and as I just said, I am holding on to my physical gold) is that things will get one day so bad in the world that governments will expropriate gold, as the US did

in 1933. This is unlikely to happen this year but it is a concern I have for the long term, especially if gold rallies to several thousand dollars per ounce as a result of money printing by all central banks or because of wars! As Voltaire remarked, “it is dangerous to be right when the government is wrong.”

In this situation the safest would be to hold gold in countries with a strong gold tradition such as Canada, Australia, France, the Middle East, India, and most Asian countries. As for Switzerland, where I am holding my gold now, I am afraid that the Swiss have now shown twice that they are bending to demands from the US on the slightest pressure. Moreover, the totally incompetent Swiss National Bank (they have very good company among other central bankers) having sold part of its gold reserves below \$300 will be only too happy to replenish its reserves by taking gold away from individuals who store their gold in Swiss banks. As I said, I do not expect this to happen soon, but it is a concern of mine – this especially since physical gold is held by a very small minority of the population.

The supply of US government securities is likely to exceed \$2 trillion in 2009. With foreign current account surpluses turning down or moving into deficits I cannot see how “the market” will absorb this supply without driving rates higher. For sure the Fed will monetize a massive amount of the new government bond issues in order to try preventing interest rates from rising too much. However, in my opinion, this will lead to even weaker government bond prices and intensify the bear market in long US government bonds, which began on December 21, 2008 when the 30-year government bond yield approached 2.50% (see Figure 12).

Figure 12: US 30-Year Treasury Bond Yield, 2006 - 2009

Source: www.decisionpoint.com

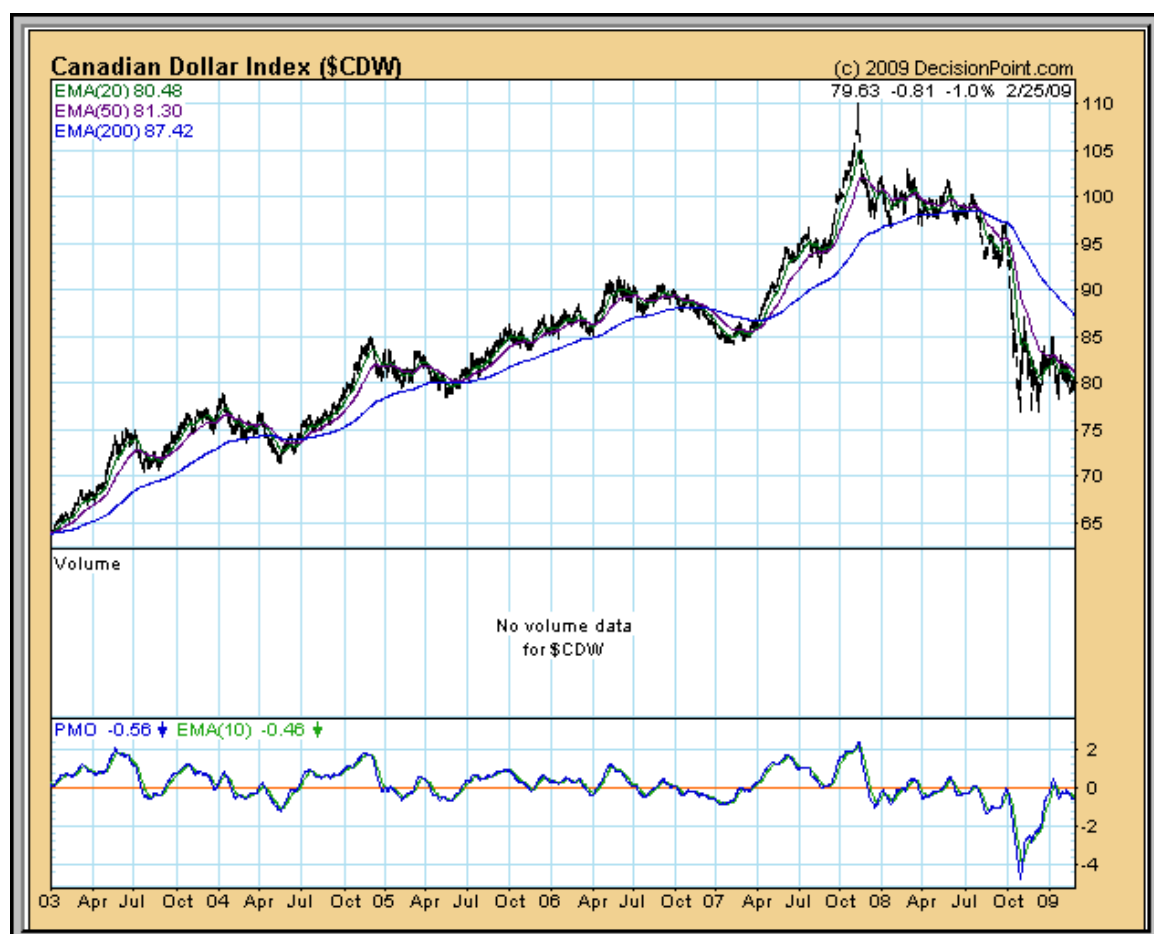
Perhaps government bond yields will first decline somewhat, but on any US government bond market recovery, selling and short selling is advised. You must not forget that we have a money printer par excellence at the Fed who said that under a fiat (that is, paper) money system (I call it a Madoff money system), “the central bank should always be able to generate inflation.”

According to Mr. Bernanke, "The conclusion that deflation is always reversible under a fiat money system follows from basic economic reasoning...U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the

prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

I, therefore, expect that at some point the Fed's money printing will be effective in lifting real estate and equity prices, but at the cost of weakening government bonds and the US dollar. In fact, for this reason I would consider taking a small long position in Euros against the USD and in commodity related currencies such as the Australian (XAD) and the Canadian dollar (CDW) with a tight stop (see Figure 13). This would fit with the theme of rebounding commodity prices (see above).

Figure 13: Canadian Dollar, 2003 - 2009



Source: www.decisionpoint.com

Lastly, contrary to widespread views, a break-away from the Eurozone by some weaker members should be Euro positive (see Figure 14).

Figure 14: Euro Index, 2003 - 2008

Source: www.decisionpoint.com

All I am suggesting is that investors should be prepared or begin to diversify their currency exposure for the day US “money printing” will lift asset prices and weaken the US dollar.

Once again I need to stress that it is physically impossible to answer all emails and I simply cannot be each reader’s personal financial consultant since I do not know each reader’s financial conditions, time horizon, and investment objectives.

I am also enclosing a report by my friend Faizal Azar Kalla (azarkalla@gmail.com) about important accounting issues.